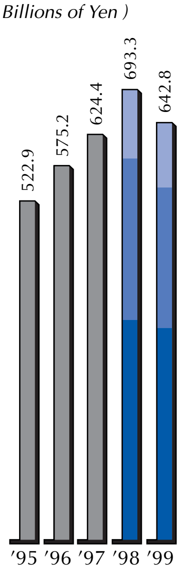
Management's Discussion and Analysis of Operations

Shin-Etsu Chemical Co., Ltd. and Subsidiaries
For the years ended 31st March

	31st March,						31st March,
	1994	1995	1996	1997	1998	**1999**	**1999**
	(millions of yen)						(thousands of U.S. dollars)
For the Year:							
Net sales	¥464,449	¥522,917	¥575,176	¥624,405	¥ 693,275	**¥ 642,796**	**$5,312,364**
Operating income	32,450	51,914	73,427	82,024	90,860	**86,323**	**713,413**
Net income	17,547	26,862	37,825	40,614	42,027	**43,363**	**358,372**
Capital expenditures	34,421	67,689	66,791	92,844	136,384	**73,641**	**608,603**
Depreciation	40,351	42,986	45,647	52,191	62,144	**56,196**	**464,430**
Net income per share (in yen, dollars)	54.17	82.80	116.51	118.24	110.73	**109.36**	**0.904**
Cash dividends per share (in yen, dollars)	7.50	7.50	7.50	7.50	8.50	**9.00**	**0.074**
At year-end:							
Total assets	¥600,754	¥643,937	¥708,637	¥931,159	¥1,083,780	**¥1,060,973**	**$8,768,372**
Working capital	94,362	110,901	118,936	195,729	221,869	**261,691**	**2,162,736**
Stockholders' equity	265,030	285,361	320,987	374,726	497,312	**564,067**	**4,661,711**
Short-term and long-term debt	173,304	172,280	171,865	271,860	269,395	**251,060**	**2,074,877**

Note: The U.S. dollar amounts represent conversions of Japanese yen, for convenience only, at the rate of ¥121=$1.

Net Sales
(Billions of Yen)



Organic and Inorganic Chemicals
Electronics Materials
Functional Materials and Others

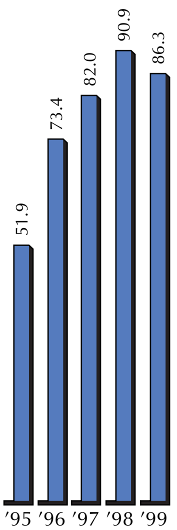
Overview of Business Segments

In accordance with the nature of products, sales areas and other factors, the operations of Shin-Etsu Chemical Co,. Ltd., (the "Company") and its subsidiaries (the "Companies") are divided into the following three business segments: **Organic and Inorganic Chemicals**, where main products are polyvinyl chloride (PVC), silicones, vinyl acetate monomer, methanol and cellulose derivatives; **Electronics Materials**, where main products are semiconductor silicon, organic materials for the electronics industry, and rare earth magnets for the electronics industry; and **Functional Materials and Others**, where the main products are synthetic quartz, oxide single crystal, rare earths, rare earth magnets for applications outside the electronics industry, as well as the export of technology and plants, export and import of merchandise, construction and plant engineering, and information processing services. Consolidated data include the results of the Company and 58 subsidiaries in Japan and overseas. The equity method of accounting is applied to 2 of the 41 unconsolidated subsidiaries and 7 of the 21 affiliated companies.

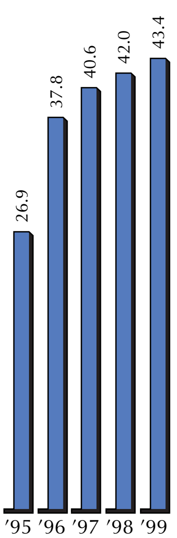
Operating Environment

The Japanese economy remained in an extremely weakened state during the fiscal year that ended on 31st March, 1999. Although some encouraging signs became apparent early in 1999, markets were buffeted by concerns about Japan's financial system, the Asian economic crisis and other factors. This prolonged the weakness in consumer spending and housing construction and led to a big decline in capital expenditures. In the United States, the economy continued to expand as domestic demand remained robust, chiefly backed by consumer spending and private-sector housing investments, despite some uncertainty about the future. To deal with these challenges, the Companies reviewed business strategies from a long-term perspective and concentrated on developing and commercializing new products while streamlining operations wherever possible.

Operating Income
(Billions of Yen)



Net Income
(Billions of Yen)



Net Sales and Segment Information

Fiscal 1999 consolidated net sales decreased 7.3 percent to ¥642,796 million (US$5,312 million) and operating income was down 5.0 percent to ¥86,323 million (US$713 million). Although sales were down, the ratio of operating income to net sales remained at 13.4 percent. Results by segment are as follows.

Organic and Inorganic Chemicals—The figures in this segment represent operations of the Company and 34 subsidiaries, including Shintech Inc. and Shin-Etsu Polymer Co., Ltd. Fiscal 1999 segment sales decreased 3.3 percent to ¥328,925 million (US$2,718 million) and accounted for 51.2 percent of total sales. Demand in the U.S. for PVC continued to climb but shipments in Japan fell due to weakness in such key client industries as housing, construction and automobiles. Silicone results were hurt by soft demand in Japan, notably from manufacturers of electrical equipment and automobiles, and by the yen's strength in the second half of the fiscal year. Sales of other organic and inorganic chemical products were generally flat. Despite the lower sales, segment operating income increased 24.1 percent to ¥44,366 million (US$367 million). Profitability benefited from a broad-based effort to boost efficiency and streamline operations, such as by increasing sales of value-added products.

Electronics Materials—The Company and 15 subsidiaries are included in this segment. Major subsidiaries are Shin-Etsu Handotai Co., Ltd., Shin-Etsu Handotai America, Inc., and S.E.H. Malaysia Sdn. Bhd. Segment sales fell 13.4 percent to ¥214,605 million (US$1,774 million), 33.4 percent of total sales. A slumping semiconductor industry caused wafer prices to drop. Sales in Asia began to climb during the year's second half, but this growth was insufficient to lift sales for the entire year. Photoresist for excimer laser photolithography posted higher sales. Operating income was down 30.8 percent to ¥29,398 million (US$243 million).

Functional Materials and Others—The results of the Company and 15 subsidiaries, including Shin-Etsu Astech Co., Ltd. and Shin-Etsu Engineering Co., Ltd., are included in this segment. In fiscal 1999, sales declined 5.9 percent to ¥99,266 million (US$820 million) and accounted for 15.4 percent of total sales. Synthetic quartz sales were lower because of soft orders in both the electronics and optical fiber industries. The export and import of merchandise remained stable, but Japan's weakened economy brought down sales from construction and repairs. Operating income decreased 2.5 percent to ¥12,798 million (US$106 million).

Other Income (Expenses) and Net Income

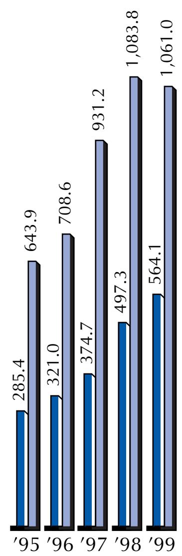
Interest and dividend income was ¥10,029 million (US$83 million), about the same as one year earlier. **Interest expense** rose 17.7 percent to ¥10,855 million (US$90 million) as growth in short-term borrowings offset a decline in long-term debt. The **foreign exchange loss** was ¥11,246 million (US$93 million), much higher than in the previous fiscal year because of the yen's appreciation in the second half of fiscal 1999. **Equity in earnings of affiliates**, which is included in other income (expense) for the first time in fiscal 1999, totaled ¥564 million (US$5 million). After inclusion of other items, **other income/(expenses)** amounted to a net expense of ¥9,116 million (US$75 million).

Income before income taxes was down by 12.9 percent to ¥77,207 million (US$638 million) because of the decline in operating income and the increase in net other expenses. However, **consolidated net income** increased 3.2 percent to ¥43,363 million (US$358 million) because of a 31.1 percent drop in income taxes to ¥32,315 million (US$267 million). **Minority interests in earnings of consolidated subsidiaries** was ¥1,529 million (US$13 million). This resulted in **primary net income per share** of ¥109.36 (US$0.90).

Overseas Operations

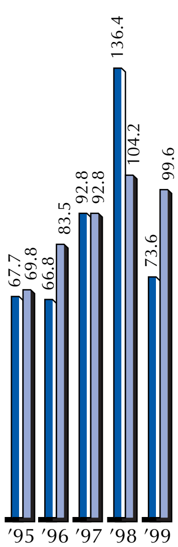
The sales of foreign subsidiaries declined 9.9 percent to ¥222,515 million (US$1,839 million) and was 34.6 percent of total sales, down from 35.6 percent one year earlier. Lower sales of semiconductor silicon was the most significant cause for the decrease.

Stockholders' Equity/ Total Assets
(Billions of Yen)



Stockholders' Equity
Total Assets

Capital Expenditures/ Net Cash Flows
(Billions of Yen)



Capital Expenditures
Net Cash Flows
(Net Income plus Depreciation)

Financial Position

As of 31st March, 1999, current assets totaled ¥523,321 million (US$4,325 million), a 4.1 percent year-on-year decline. Cash and time deposits decreased 7.0 percent to ¥184,021 million (US$1,521 million) because of purchases of short-term marketable securities, which rose by 7.2 percent to ¥76,336 million (US$631 million), and growth in inventories. Despite an extremely difficult operating environment, the Companies were able to limit the increase in inventories to 8.3 percent, resulting in a term-end balance of ¥94,421 million (US$780 million). Investments in securities declined 1.8 percent to ¥89,910 million (US$743 million). Tangible fixed assets increased only 0.3 percent to ¥391,465 million (US$3,235 million) as the Companies reduced capital expenditures to the minimum. As a result, total assets were ¥1,060,973 million (US$8,768 million), 2.1 percent less than one year earlier.

Current liabilities declined 19.2 percent to ¥261,630 million (US$2,162 million). Notes and accounts payable and accrued taxes were lower and the current portion of long-term debt decreased because of the conversion of convertible bonds. Long-term debt decreased 4.0 percent to ¥169,255 million (US$1,399 million) due to the redemption of bonds, the conversion of convertible bonds and efforts to reduce long-term borrowings. The conversion of convertible bonds and higher retained earnings lifted stockholders' equity by 13.4 percent to ¥564,067 million (US$4,662 million) and the equity ratio rose to 53.2 percent. Note that retained earnings and legal reserve have been combined into a single balance sheet item beginning with this fiscal year.

At the stockholders meeting held in June 1999, approval was given for the acquisition of treasury stock for the purpose of granting stock options. The amendment to the Articles of Incorporation provides for the acquisition of no more than 759 thousand shares of the Company's par-value common stock at a cost not to exceed ¥3,800 million (US$31 million).

Capital Expenditures

In fiscal 1999, capital expenditures were ¥73,641 million (US$609 million), 46.0 percent less than one year earlier. The decrease is mostly attributable to the decision to limit additions to facilities for semiconductor silicon and other electronic materials. During the five-year period ending in March 2004, the Company, subsidiaries and affiliated companies plan to make capital expenditures of approximately ¥450 billion (US$3,719 million). These investments will be used primarily to expand and streamline production activities and to install environmental systems.

Cash Flows

Cash and cash equivalents at the end of fiscal 1999 were ¥260,357 million (US$2,152 million), 3.3 percent less than at the end of fiscal 1998. Net cash provided by operating activities was ¥64,353 million (US$532 million). Net income was higher but depreciation and amortization declined. Net cash used for investing activities was ¥70,976 million (US$587 million), mainly due to the decrease in capital expenditures. Net cash provided by financing activities was ¥3,074 million (US$25 million). This is mainly attributable to absence of proceeds from the issue of debentures.

Year 2000

Having recognized the Year 2000 (Y2K) problem as a vital management issue, the Companies began working on this issue in October 1996. Since then, the scope of this process has expanded to include manufacturing equipment, utilities and suppliers. To oversee Y2K efforts, the Year 2000 Committee was formed on 1st August, 1998 and a vice president was named as its chairman. In the field of data processing systems, all operating programs were checked, individual programs were revised and tests were conducted to verify Y2K compliance. Regarding manufacturing equipment and utilities, work began in November 1997 to prepare a list of applicable equipment so that inspections and corrective actions and tests could be conducted. Y2K compliance at suppliers has also been monitored. As of June 1999, Y2K compliance actions had been almost completed. With regard to risk management plans, a contingency plan was formulated in June 1999. This plan covers all internal activities as well as all major transactions. Individual plans have been prepared to deal with unforeseen risks with regard to products, customers, production systems and internal data processing systems. The Companies, however, can not offer guarantees or warranties because there may be critical third parties, including suppliers and customers, who are not Y2K-ready on a timely basis.